

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Washington Analyst: Jeani Brent Bill Number: AB 356
Related Bills: AB 1937
(1997/1998) Telephone: 845-3410 Introduced Date: 02/11/1999
Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Enterprise Zones/Authorizes Additional Designation of One City Within
Los Angeles County

SUMMARY

Under the Government Code, this bill would require the Trade and Commerce Agency (TCA) to designate one city within Los Angeles County as an additional enterprise zone. This bill would specify that TCA could designate only a city that meets certain additional criteria.

This bill would provide that all tax incentives provided to existing enterprise zones under the Revenue and Taxation Code would apply to the enterprise zone designated under this bill.

EFFECTIVE DATE

This bill would be effective on January 1, 2000, and would apply to taxable or income years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

AB 51, SB 84 (1999); AB 3 (Stats. 1998, Ch. 1012), AB 2798 (Stats. 1998, Ch. 323), AB 2809 (Stats. 1998, Ch. 1039); AB 69, AB 82, AB 638, AB 809, AB 1217 (Stats. 1997, Ch. 602), SB 200 (Stats. 1997, Ch. 609), SB 635, SB 965 (Stats. 1997, Ch. 603); AB 2456 (1996), AB 296 (Stats. 1996, Ch. 953), SB 715 (Stats. 1996, Ch. 952), SB 2023 (Stats. 1996, Ch. 955); SB 712 (Stats. 1995, Ch. 494); AB 2206 (Stats. 1994, Ch. 853), SB 1438 (Stats. 1994, Ch. 754), SB 1770 (Stats. 1994, Ch. 755).

PROGRAM HISTORY/BACKGROUND

California has four types of economic development areas that have similar tax incentives:

- Enterprise Zones,
- Local Agency Military Base Recovery Areas (LAMBRA),
- Targeted Tax Area (TTA), and
- Manufacturing Enhancement Areas (MEA)

Board Position:

| | | |
|----------|-----------|-----------------|
| _____ S | _____ NA | _____ NP |
| _____ SA | _____ O | _____ NAR |
| _____ N | _____ OUA | _____ X PENDING |

Department Director

Date

Gerald Goldberg

3/23/1999

The following table shows the incentives available to each of the economic development areas.

| Types of Incentives | EZ | LAMBRA | TTA | MEA |
|----------------------------|----|--------|-----|-----|
| Sales or Use Tax Credit | X | X | X | |
| Hiring Credit | X | X | X | X |
| Employee Wage Credit | X | | | |
| Business Expense Deduction | X | X | X | |
| Net Interest Deduction | X | | | |
| Net Operating Loss | X | X | X | |

SPECIFIC FINDINGS

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an enterprise zone. Using specified criteria, the Trade and Commerce Agency (TCA) designates enterprise zones from the applications received from the governing bodies. Enterprise zones are designated for 15 years (except enterprise zones meeting certain criteria may be extended to 20 years), and TCA has designated each of the 39 enterprise zones authorized under existing law. When an enterprise zone expires, TCA is authorized to designate another in its place (or redesignate the existing zone) to maintain a total of 39 enterprise zones. TCA may approve the geographic expansion of enterprise zones up to 15% in size and, for certain small enterprise zones, up to 20% in size.

TCA may audit enterprise zone programs and determine a result of superior, pass, or fail, and may dedesignate failing programs. Any business located in a dedesignated zone that has elected to avail itself of any state tax incentive for any taxable or income year prior to dedesignation may continue to avail itself of those tax incentives for a period equal to the remaining life of the enterprise zone, provided the business otherwise is still eligible for those incentives. Once an enterprise zone is dedesignated, it is no longer an enterprise zone for designation purposes. Thus, once an enterprise zone is dedesignated, TCA may designate another enterprise zone in its place to maintain a total of 39 enterprise zones, even though taxpayers in the dedesignated zone may continue to use the tax incentives that the taxpayers qualified for prior to dedesignation.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within an enterprise zone. These incentives include a sales or use tax credit, hiring credit, business expense deduction, special net operating loss treatment, and net interest deduction. In addition, a wage credit may be claimed by specified employees of businesses operating within an enterprise zone. See attachment A for a detailed discussion of each tax incentive.

This bill would require the TCA to designate one city within Los Angeles County as an additional enterprise zone. To qualify for designation as an enterprise zone under this bill, a city must meet each of the criteria listed below:

1. An average unemployment rate for the entire city that was not less than 10% in 1998.
2. The median annual household or family income for the entire applicant city is not more than \$26,500.

3. The percentage of persons in the entire applicant city below the poverty level is at least 25%.
4. The applicant is an incorporated city in the County of Los Angeles that has a population of less than 100,000 persons according to the most recent census data.

According to TCA, three cities meet these criteria: Bell, Bell Gardens, and Compton.

This bill would specify that all tax incentives provided to existing enterprise zones under the Revenue and Taxation Code would apply to the new enterprise zone designated under this bill.

Policy Consideration

This bill does not specify the duration of the enterprise zone designation that would be provided under this bill.

This bill does not specify that the new area must meet the general enterprise zone designation criteria that currently require that the application propose effective, innovative, and comprehensive regulatory, tax, program, and other incentives in attracting private sector investment to the enterprise zone.

Unlike most economic development areas where a definitive geographic area within a city is designated, this bill would allow an entire city to be designated.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue loss from this bill is estimated as follows:

| Effective After January 1, 2000 Assumed Enactment After June 30, 1999 (In Millions) | | |
|---|---------------|--------|
| 1999-0 | 2000-1 | 2001-2 |
| Neg. Loss * | Minor Loss ** | (\$1) |

* Less than \$250,000

** Less than \$500,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Estimate Discussion

Revenue losses under the Personal Income Tax Law and the Bank and Corporation Tax Law largely would depend on the number of businesses that would purchase qualified property subject to sales tax, the amount of wages paid to qualifying employees, and the state tax liabilities of employers claiming tax benefits.

For 1996 tax year, the total revenue loss for the 37 existing zones was \$39 million (average impact of \$1 million per zone). Because this designation applies to a city in Los Angeles County (Bell, Bell Gardens, or Compton) and the revenue loss for existing enterprise zone in that area of Los Angeles County tends to be below the average, revenue losses under this bill most likely would be somewhat below the average in the first years of designation. Allowance is made in future years for new businesses that might start up within this enterprise zone.

BOARD POSITION

Pending.

ENTERPRISE ZONE TAX INCENTIVES

Sales or Use Tax Credit

The enterprise zone sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property purchased for exclusive use in an enterprise zone. The amount of the credit is limited to the tax attributable to enterprise zone income. Qualified property is defined as:

- Machinery and machinery parts used to
 - (1) manufacture, process, combine, or otherwise fabricate a product;
 - (2) produce renewable energy resources; or
 - (3) control air or water pollution.
- Data processing and communication equipment.
- Motion picture manufacturing equipment.

In addition, qualified property must be purchased and placed in service before the enterprise zone designation expires. The maximum value of property that may be eligible for the enterprise zone sales or use tax credit is \$1 million for individuals and \$20 million for corporations.

Hiring Credit

A business located in an enterprise zone may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated an enterprise zone and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the enterprise zone and at least 50% must be performed inside the enterprise zone. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on enterprise zone income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage. The amount of the credit must be reduced by any other federal or state jobs tax credits, and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

Business Expense Deduction

A business located in an enterprise zone may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the enterprise zone. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. The basis of the property must be reduced by the amount of the deduction. The maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

Attachment A

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If the property was placed in service:

| Months after Designation | Maximum deduction |
|--------------------------|-------------------|
| 0 to 24 | \$40,000 |
| 25 to 48 | 30,000 |
| 48 and over | 20,000 |

Net Operating Loss Deduction

A business located in an enterprise zone may elect to carry over 100% of the enterprise zone net operating losses (NOLs) to deduct from enterprise zone income of future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity in the enterprise zone.

Net Interest Deduction

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an enterprise zone. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the enterprise zone, and the lender may not have equity or other ownership interest in the enterprise zone trade or business.

Employee Wage Credit

Certain disadvantaged individuals are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for the credit. The amount of the credit is 5% of "qualified wages," defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment in the enterprise zone, computed as though that income represented the taxpayer's entire taxable income.

Apportioning

For businesses operating inside and outside an enterprise zone, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax or income attributable to the enterprise zone. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the enterprise zone using a two-factor formula based on the property and payroll of the business.